No. 11796.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

Central Investment Corporation,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

PETITIONER'S OPENING BRIEF.

Joseph D. Brady,
John O. Paulston,
c/o Brady & Nossaman, 433 South Spring Street,
Los Angeles 13, California,
Counsel for Petitioner.

Parker & Company, Law Printers, Los Angeles. Phone TR. 5206.

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Opinion Below.

The opinion of the Tax Court [R. 52-59] is reported in 9 T. C. 128.

Jurisdiction.

The petition herein is to review the decision of the Tax Court of the United States involving taxpayer's excess profits tax liability for the calendar year 1943.

The jurisdiction of the Tax Court is based upon Section 1012(a) of the Internal Revenue Code. The jurisdiction of this Court is based on Sections 1141 and 1142 of the Internal Revenue Code.

The pleadings and facts supporting such jurisdiction are as follows:

Petitioner's Federal excess profits tax return for the calendar year 1943 was filed with the Collector of Internal Revenue for the Sixth District of California, at Los Angeles. [R. 47.] Respondent determined a deficiency in petitioner's excess profits tax liability in the amount of $34,971.23, and notified petitioner of this determination under date of March 21, 1945. [R. 8-13.] Petition for redetermination [R. 3-13] was filed with the Tax Court on May 8, 1945. [R. 2.]

The Tax Court (per Hill, Judge) promulgated its Findings of Fact and Opinion on July 30, 1947. [R. 46-59.] The Decision of the Tax Court, pursuant to said Findings of Fact and Opinion, that there is a deficiency in excess profits tax for the calendar year 1943 in the amount of $34,971.23, was entered on July 31, 1947. [R. 60.] Petitioner's motion for a review by the entire Tax Court, filed August 19, 1947, was denied by the Presiding Judge on August 21, 1947. [R. 74.] Taxpayer's petition for review was filed on October 30, 1947. [R. 75-79.]

Question Presented.

Is petitioner, which keeps its books on the accrual basis, entitled, under Section 23(c)(1), Internal Revenue Code, to a deduction for its taxable year ended December 31, 1943, in the amount of $43,174.36, for a California franchise tax which, under the law of California, accrued and became a lien on December 31, 1943?

Statutes and Regulations Involved.

The statutes and regulations involved are as follows:

Internal Revenue Code, Sections 23(c), 41, 43, and 48(c);

Regulations 111, Sections 29.23(c)-1, 29.41-1, 29.41-2, 29.41-3, 29.43-1, and 29.43-2;

California Bank and Corporation Franchise Tax Act (California Statutes 1929, page 19, as amended to and in effect on December 31, 1943), Sections 4(3), 4(5), 4(7), 5, 11, 13, 22, 23 (part) and 29.

These statutory provisions and regulations, together with the applicable portions of regulations and rulings by the California Franchise Tax Commissioner (there being no official publication of the latter regulations and rulings), are set forth in the Appendix hereto.

Statement of the Case.

Petitioner is a California corporation organized October 6, 1921, with its principal office and place of business at Los Angeles, California. [R. 3, 14, 47.] It is the owner of the real property known as the Biltmore Hotel in that city. [R. 4-5, 14, 47.] At all times material hereto it was subject to the provisions of the California Bank and Corporation Franchise Tax Act (California Statutes 1929, page 19, Chapter 13, as amended; hereinafter referred to as the Franchise Tax Act or the Act), which was enacted in 1929. [R. 4-5, 14, 47.]

This Act imposes[1] an annual tax on corporations, for the privilege of exercising their corporate franchises with-

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[1]References herein to the Act in the present tense include also the taxable year in question, viz., 1943, unless the context indicates otherwise.

in this state, according to or measured by net income, at the rate of 4 per centum upon the taxpayer's net income for its next preceding fiscal or calendar year.[2] Since 1935, the year the net income of which forms the basis for the tax has been known as the "income year," and the year for and in which the tax is payable has been known as the "taxable year."[3] (Act, Sec. 11(a) and (b).)

This tax is in lieu of all *ad valorem* taxes and assessments of every kind and nature upon the general corporate franchises of the corporations so taxed. (Act, sec. 4(7).) If the corporation completely ceases business activities in any corporate form during the year in and for which the tax is paid, the amount of the tax is reduced proportionately, *but in no event may it be below the minimum amount specified in the statute.* (Act, secs. 13(k), 13(h), 4(3), 4(5). See also sec. 13(1).)

For some time prior to 1943 the Act had expressly provided that the taxes thereby imposed "shall accrue on the first day of the 'taxable year' * * *" (Act, sec. 4(7), as amended by Cal. Stats. 1935, p. 960), and should constitute a lien upon the real property of the taxpayer, which lien "shall attach on the first day of the 'taxable year' * * *."[4] (Act, sec. 29, as amended by Cal. Stats. 1935, p. 979.) The Act expressly provided that this lien "shall have the same force, effect and priority as a judg-

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[2]A special credit of 15% was allowed by Section 7.5 of the Act, with respect to taxable years beginning after December 31, 1943.

[3]In referring to earlier authorities, it should be borne in mind that prior to 1935 the year the income of which formed the basis for the tax was known as the "taxable year." (See Cal. Stats. 1929, p. 25, sec. 11.)

[4]In the case of commencing corporations the lien of taxes for the first taxable year attaches at the time of incorporation or qualification to do business in this State.

ment lien" and "shall remain until the taxes are paid or the property subject to the lien is sold for the payment thereof, or until the lien is released or otherwise extinguished." (*Ibid.*)

In 1943 the California Legislature changed the date when the lien attached (for other than commencing corporations) to the *last* day of the *"income* year," and changed the statutory "accrual" date to conform to the "lien" date as so modified (Act, sec. 4(7), and 29(a), respectively, as amended by Cal. Stats. 1943, Ch. 352, at pages 1404 and 1458). The act adopting these amendments was approved by the Governor and filed with the Secretary of State on May 7, 1943, and became effective immediately (Cal. Stats. 1943, Ch. 352, p. 1403), and the California Franchise Tax Commissioner ruled that they were applicable with respect to any income year ending after such effective date. [Informal letter ruling of Franchise Tax Commissioner, Cal. C. T., par. 5-951.02, Appendix hereto, p. 16.]

At all times material hereto petitioner's annual accounting period has been the calendar year and petitioner has kept its books of account and made and filed its Federal income and excess profits tax returns on the accrual basis, which basis admittedly clearly reflects its income. [R. 5, 14; *cf*. R. 47.] Petitioner did not, on December 31, 1943, or at any other time material hereto, have pending any negotiations for the possible sale of its Biltmore Hotel property, nor did it contemplate dissolution or liquidation. [R. 5, 14, 47.] Accordingly, before closing its books of account for the calendar year 1943, it set up therein a liability of $43,174.36, as of December 31, 1943, for the tax which it correctly computed under the Franchise Tax Act on the basis of its net income for 1943. It did not

then or at any other time dispute its liability for the full amount of said tax. [R. 6, 14, 51.]

The taxpayer is required by the Act, to file its tax return within two months and fifteen days after the close of its "income year." (Act, sec. 13(a).) One-half of the tax is due and payable with the return, and the balance on or before the fifteenth day of the ninth month following the close of the "income year." (Act, sec. 23.) Accordingly, in 1944 petitioner duly filed its California franchise tax return showing said franchise tax liability based on its 1943 net income, and duly paid the full amount thereof. Petitioner has never filed any claim for refund or credit for the whole or any part thereof, and has never had, and does not now have, any intention of filing any such claim. [R. 5, 6, 14, 50-51.]

In petitioner's Federal income and excess profits tax returns for the calendar year 1943 a deduction was claimed and taken for said franchise tax in the amount of $43,174.36. [R. 6, 14.] Also, as the Tax Court found from evidence adduced by respondent at the trial, petitioner claimed a deduction in its Federal excess profits tax return for the calendar year 1943 for the California franchise tax in the amount of $19,736.60 imposed on the basis of its net income in 1942 and duly paid by petitioner in 1943. [R. 51.] As hereinbefore stated, the Franchise Tax Act expressly provided, prior to the 1943 amendments, that the franchise tax accrued and became a lien on the first day of the "taxable year." January 1, 1943, was the first day of petitioner's "taxable year" with respect to which said tax of $19,736.60 was imposed.

In determining the deficiency respondent disallowed in its entirety the deduction of $43,174.36 claimed for the franchise tax based upon petitioner's 1943 net income.

[R. 6, 14, 47.] In his Statement accompanying the deficiency notice with respect to 1943, respondent stated [R. 12]:

> EXPLANATION OF ADJUSTMENT
>
> California State franchise tax paid during the year 1944, amounting to $43,174.36, treated as a deduction on your return for the calendar year 1943 is disallowed, since it is held that such taxes are properly allowable and deductible during the calendar year 1944 under section 23(c) of the Internal Revenue Code.

The Tax Court sustained respondent's determination. [R. 46-60.]

It should be further noted that after the petition was filed with the Tax Court, and on or about May 17, 1945, petitioner, without admitting that any part of the alleged deficiency for 1943 was properly owing, but in order to prevent further accrual of interest thereon, consented, on Treasury Department Form 874, to the assessment and collection of a deficiency in excess profits in said amount of $34,971.23, together with interest thereon as provided by law. Pursuant to this consent, the Bureau of Internal Revenue prepared its assessment and issued its notice and demand thereon. Accordingly, on July 31, 1945, petitioner paid in full the amount of said assessment and interest thereon. If the Tax Court had rendered its decision in favor of petitioner, and found that there was no deficiency in excess profits tax for 1943, it would have been required to determine the amount of overpayment by reason of the aforesaid payment by petitioner after the filing of the petition with the Tax Court. (Sec. 322(d), I. R. C.) The full amount of the asserted deficiency having thus been paid before the decision by the Tax Court, no bond

was filed to stay the assessment and collection thereof. (See sec. 1145, I. R. C.) Therefore, upon a decision by this court that the Tax Court erred in its decision herein, it is submitted that the appropriate disposition of the case would be to reverse the decision of the Tax Court and remand the case for a hearing and finding by that court upon the sole question of the overpayment of the tax here in question (see sec. 1141(c)(1), I. R. C.), and for entry of decision accordingly.

Specification of Errors Relied Upon.

The points upon which petitioner on review intends to rely upon this review are as follows:

1. The Tax Court of the United States erred in holding and deciding that the amount of $43,174.36, which was the amount of the California franchise tax based upon petitioner's net income for the calendar year 1943, did not accrue on December 31, 1943.

2. The Tax Court of the United States erred in holding and deciding that said amount of $43,174.36 was not deductible by petitioner in computing its net income for federal income and excess profits tax purposes for the calendar year 1943.

3. The Tax Court of the United States erred in holding and deciding that said amount of $43,174.36 was deductible by petitioner in computing its net income for federal income and excess profits tax purposes for the calendar year 1944 only.

4. The Tax Court of the United States erred in holding and deciding that there was any deficiency in any sum whatsoever in the payment of petitioner's excess profits tax for the year 1943.

5. The Tax Court of the United States erred in rendering an opinion and decision which, in the respects above enumerated, are contrary to the controlling law and the regulations, and are not supported by any evidence in the case.

Summary of Petitioner's Argument.

A clear question of law is presented.

Section 23(c) of the Internal Revenue Code provides for a deduction of taxes "paid or accrued within the taxable year * * *." Whether state taxes have "accrued within the taxable year" must be determined by the provisions of the state taxing statute.

Under the express provisions of the California Bank and Corporation Franchise Tax Act, liability for the franchise tax imposed thereby arose, and a lien therefor attached to the real property of the taxpayer, on the last day of the year the income of which formed the basis for the tax. Pursuant to these provisions, petitioner properly accrued on its books of account on December 31, 1943, its liability for the California franchise tax based upon its 1943 net income, and deducted the amount so accrued in its Federal excess profits tax return for its calendar year 1943.

The Tax Court erred in disregarding the controlling state law and in holding that petitioner was not entitled to the deduction claimed, in 1943, upon the alleged grounds that liability for the franchise tax did not arise until 1944, the year *for* which the tax was imposed, and that the tax was required to be deducted in 1944 in order "to properly reflect" petitioner's net income.

ARGUMENT.

I.

The Reviewing Powers of This Court in the Present Case Are Not Restricted by the Principle of the Dobson Case.

The Tax Court held that petitioner was not entitled to a deduction, in its excess profits tax return for the year 1943, of the amount of the California franchise tax based upon its 1943 net income. This holding was made notwithstanding the local taxing statute *expressly* provided that the taxes thereby imposed accrued and became a lien on the real property of the taxpayer on the last day of the taxpayer's "income year"—*i. e.,* the year on the income of which the tax is based—and notwithstanding petitioner had, in accordance with said provision, set up on its books of account as of December 31, 1943, its liability for said tax based on its net income for 1943.

In reaching this decision, the Tax Court was required to interpret certain provisions of the California Franchise Tax Act and of the Internal Revenue Code. As to the former, it held that "* * * the provisions of the [Franchise Tax] Act, specifying the last day of the 'income year' as the time of accrual and as the lien date, are for a special and limited purpose only, *i. e.,* priority of liens * * *." [9 T. C. 134, R 58-59.] As to the latter, it held, in effect, that the provisions of the Internal Revenue Code relating to deductions for taxes by a taxpayer on the accrual basis precluded a deduction for state franchise taxes in any year other than the privilege year *for* which the tax is paid, despite provisions of the local taxing statute expressly designating an earlier date as the accrual and lien date for the taxes thereby imposed.

Thus, the questions involved upon this review are (1) whether the Tax Court erred in its interpretation of the provisions of the California Franchise Tax Act specifying the date for the accrual of liability for the franchise tax and for the attaching of the lien in support thereof, and (2) whether the Tax Court erred in its interpretation of the provisions of the Internal Revenue Code relating to deductions for taxes by a taxpayer on the accrual basis. The question is *not* whether the Tax Court, within its discretion, made a determination of *fact* which, under the principle established in *Dobson v. Commissioner* (1943), 320 U. S. 489, 64 S. Ct. 239, 88 L. Ed. 248, may not be disturbed on appeal. Rather, as in *Security Flour Mills Co. v. Commissioner* (1944), 321 U. S. 281, 64 S. Ct. 596, 88 L. Ed. 725, it is whether, as a matter of *law,* the Tax Court misconstrued the extent of the power conferred by the Revenue Act to determine the year in which deductions are "accrued" for Federal income tax purposes. There the Board of Tax Appeals had held[5] that the taxpayer was entitled, in reporting its income tax for the year 1935, to deduct tax payments made by it in 1936, 1937 and 1938. The Circuit Court of Appeals for the Tenth Circuit reversed[6] upon the ground that the taxpayer could not accrue said taxes in 1935, because it was at that very time contesting its liability therefor and had not in fact paid the taxes. The Supreme Court, in affirming the decision of the Circuit Court of Appeals, disposed of the possible application

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[5]45 B. T. A. 671.

[6]135 F. (2d) 165.

of the *Dobson* case in support of the decision by the Board of Tax Appeals by saying (321 U. S. 286, 64 S. Ct. 598, 88 L. Ed. 729):

> The question is not whether the Board within its discretion, made a determination of fact. Compare Dobson v. Helvering, 320 U. S. 489, 64 S. Ct. 239. It is rather whether, as matter of law, the Board misconstrued the extent of the power conferred by the Revenue Act.

The same is clearly true in the present case.

II.

Petitioner Properly Accrued on Its Books of Account as of December 31, 1943, Its Liability for the California Franchise Tax Based Upon Its 1943 Net Income.

The pertinent provisions of the California Franchise Tax Act have been summarized in the Statement of the Case. As there pointed out, the Act as amended in 1943 expressly provides that the tax accrues and the lien in support thereof attaches to the real property of the taxpayer on the last day of the "income year," instead of on the first day of the "taxable year," as was the case for some time prior to 1943. The "income year" is the year on the income of which the franchise tax is based, and the "taxable year" is the year *for* which the tax is imposed.

Pursuant to these statutory provisions, petitioner set up on its books of account as of December 31, 1943, before closing its books for the calendar year 1943, a franchise tax in the amount of $43,174.36. This was the correct tax computed for its "taxable year" 1944 on the basis of

its net income for the "income year" 1943. As will now be shown, petitioner was *required* so to accrue its liability, if its books, on the accrual basis, were to show a true picture of its legal liabilities as of December 31, 1943.

It is well settled that the Legislature has power to establish the lien and accrual date for taxes imposed by it, at any time chosen by it, even though such designated time is prior to the taking of the necessary steps to fix the amount of the tax, and prior to the commencement of the period *for* which the tax is imposed. And when the accrual and lien date is specified in the taxing statute, this fixes the time when *liability* accrues and the *lien* in support thereof attaches. This is true not only as between the taxing entity and the taxpayer, *i. e.,* for purposes of enforcing payment of the tax by the tax debtor, but is also true for purposes of establishing the respective priorities as between the taxing agency and other creditors of the taxpayer.

Thus, it was held by this Court in *United States v. Sampsell* (C. C. A. 9, 1946), 153 F. (2d) 731, that the provisions of the California Franchise Tax Act—as in effect in 1939 and 1940[7]—establishing the accrual and lien date as of the first day of the "taxable year," created a valid and effective lien on the property of the taxpayer, and that this lien was entitled to priority, in a bankruptcy proceeding involving the taxpayer, over the later-attaching lien of the Federal tax. The Federal government there contended that, since the statutory lien of the California tax attached before the tax was assessed, and was therefore "inchoate," whereas the lien of the Federal tax was

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[7]Act, Secs. 2(7) and 29, as amended by Cal. Stats. 1939, pp. 960, 979.

"specific," the latter lien was entitled to priority notwithstanding the former attached at an earlier date. This Court held, however, that under the local law *the state's lien was valid and effective at the date specified in the statute, and that the state lien was therefore superior.* The same conclusion undoubtedly would have been reached if the accrual and lien date of the California franchise tax had been only a *single day* in advance of the effective date of the liens of the United States.

It is to be observed that, even under the Act as involved in the *Sampsell* case, the *amount* of the California franchise tax which accrued and became a lien on the first day of the "taxable year" *might* have been reduced *if* the taxpayer completely terminated its business and dissolved (other than by way of a "reorganization"), during the "taxable year." Yet this "contingency" did not, in the opinion of this Court in deciding the *Sampsell* case, have anything to do with the validity or effect of the lien. The Legislature having prescribed that liability should accrue, and that the lien in support thereof should attach, as of the first day of the "taxable year," any *subsequent* events which *might* conceivably affect the amount of the tax were clearly in the nature of conditions subsequent, which did not affect the validity and effect of the lien for the tax at the earlier date. Further reference to this "contingency" as to the final *amount* of the tax will be made hereinbelow in discussing, separately, its effect upon the right of petitioner to a *deduction* for the amount which it accrued on its books. For the present we are considering only the

effect of the statutory accrual and lien date from a business and accounting standpoint.

See, also, as to the validity and effect of tax liens under the California law, *County of San Diego v. County of Riverside* (1899), 125 Cal. 495, 58 Pac. 81, and *In re Knox-Powell-Stockton Co.* (C. C. A. 9, 1939), 100 F. (2d) 979, both of which cases are cited with approval by this Court in its decision in the *Sampsell* case, *supra.* The *San Diego* case involves the question of the effective date of a lien for property taxes. The *Knox-Powell-Stockton* case involves the validity and priority of the lien for a California tax based on oil production, as against a claim of the United States in a bankruptcy proceeding. As in the *Sampsell* case, *supra,* this Court held that the statutory lien was valid and effective and gave the state priority over the later claim of the United States, notwithstanding at the statutory lien date the amount of the state tax not only was not fixed but was not ascertainable because it was prior to the taking of the necessary steps for the assessment of the tax. Furthermore, the lien date in the *Knox-Powell-Stockton* case was prior to the period *for* which the tax was imposed.

Although the *Sampsell* case, *supra,* directly involved the California Franchise Tax Act as in effect prior to the 1943 amendments, there is no reasonable basis for saying that the Legislature does not equally have the power to designate the *last* day of the "*income* year" as the accrual and lien date, as was done by the 1943 amendments. Certainly, as shown by the decision of this Court in the *Knox-*

Powell-Stockton case, it could not be said that the fact that the lien date specified in the 1943 amendments is prior to the period *for* which the tax is imposed requires a determination that the lien is invalid or is ineffective as of the designated lien date.

Nor is there anything so inherently "unreasonable" in the date specified in the 1943 amendments as to justify a disregard thereof. Thus, even if it were to be assumed, for the purpose of argument, that there is an implied limitation upon the power of the Legislature to the effect that it may not specify an accrual and lien date which does not bear a reasonable relationship to the realities of the situation as evidenced by the remaining provisions of the taxing statute, such limitation would be inapplicable in the present case. For the last day of the "income year" is at least *as reasonable* a date for the Legislature to specify as the date for the accrual of the tax, as is the first of the taxable year. Under the California Franchise Tax Act, *there is not a single factor which exists with any* MORE *certainty on the* FIRST *day of the* TAXABLE *year than on the* LAST *day of the* INCOME *year*. The same "contingencies" exist on either date. To say, under such circumstances, that the Legislature *cannot* effectively provide that liability for the tax shall accrue and that the lien in support thereof shall attach on the last day of the "income year," but that it *can* provide for such accrual and lien on the first day of the "taxable year," would, indeed, be splitting the proverbial hair.

There can be no question, then, that if the statutory provisions designating the last day of the "income year"

as the date for the lien to attach had been before this Court in the *Sampsell* case, such provisions would have been held valid and of *equal effect* to the designation of the first day of the "taxable year," which was upheld in that case.

The Tax Court, in its decision herein, held that the accrual and lien provisions of the California Franchise Tax Act "* * * do not affect the question of accrual for Federal tax purposes" for the reason that "These provisions of the Act, in our opinion, *only* have significance in terms of priority of liens * * *."[8] [R. 58, emphasis added.] We will discuss hereinbelow the propriety of this interpretation as it affects the right of petitioner to a deduction for Federal tax purposes. It is referred to at the present time only to consider its effect in regard to the question of the proper method to be followed by petitioner in *accruing upon its books of account* its liability for the franchise tax based on its 1943 income.

It will, of course, be observed that even the Tax Court concedes, in effect, that the provisions of the Act did, at least, "* * * have significance in terms of priority of liens * * *." [R. 58.] It clearly could not do otherwise in the light of the *Sampsell* and *Knox-Powell-Stockton* decisions, *supra*.

Necessarily, however, to have even *this* effect there must have been a *liability* to have been *supported by* the lien.

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[8]This language has been revised in the official published (but as yet unbound) version of the Opinion [see 9 T. C. 134], to be in the singular, but without changing the effect thereof.

See *East Bay Municipal Utility District v. Garrison* (1923), 191 Cal. 680. There, in holding that a tax lien was invalid because the municipal corporation purportedly imposing the tax was not in existence at the date of the alleged lien, the California Supreme Court said (pp. 692-693):

> * * * A lien, according to its general definition, is a charge imposed upon property as security for the performance of an act or obligation. (Civ. Code, secs. 2872-2875, incl.) The lien of taxes differs in no respect from other liens in that it must rest upon an obligation to do the particular act which its attachment to the property of the obligee, or another, secures. In order, therefore, for the lien of taxes to be legally imposed upon property as of the first Monday in March of any particular year it is essential to the fixation of such tax lien upon such property as of said date not only that the property itself should be in existence at the time of the attachment of such lien but also that there should be at such time an existing obligation to pay the particular tax which the lien thus imposed is to secure. Otherwise the lien would have no foundation upon which to rest and would, by the imposition of an encumbrance having no obligation to support it, amount to the taking to the extent of such encumbrance of the property of the citizen without due process of law. * * *

See, also, *County of San Diego v. County of Riverside, supra,* where, in holding that property taxes were payable to the county in which the property was included at the

time the lien attached, notwithstanding there had not then been any valid assessment of the tax, the Court said (p. 500):

> The lien for the taxes justly leviable upon the property of a railroad company attaches on the first Monday of March in each year, *and the obligation to pay necessarily accrues at the same time, if not earlier.* (Emphasis added.)

If, then, there was such statutory *liability, supported by* a statutory lien having the effect indicated by the *Sampsell* case, it is difficult to perceive how it could be said that petitioner had any alternative but to set up this liability on its books of account as of December 31, 1943. Certainly, there is no accrual method of accounting worthy of the name which would justify the taxpayer in omitting to set up on its books of account as of the date specified in the statute, a liability which is supported by a lien which is superior to any subsequently attaching lien of even the United States. The taxpayer could not say that its liability for the tax accrued at some indefinable time in 1944, when the taxing statute states, without limitation, that the tax accrues and becomes a lien on December 31, 1943. If petitioner had omitted from its accounting statement as of December 31, 1943, its liability for the franchise tax based on its 1943 income, the statement would have been directly contrary to the law and would have presented an entirely erroneous picture of its legal liabilities as of that date to its stockholders, creditors, and others.

III.

Petitioner Was Entitled to a Deduction, in Its Federal Tax Return for 1943, for the California Franchise Tax Which It Accrued on Its Books on December 31, 1943, on the Basis of Its 1943 Net Income.

It being abundantly clear that, under the provisions of the California Franchise Tax Act petitioner could not properly have done otherwise than to accrue, as it did, on its books of account as of December 31, 1943, its liability for the franchise tax based on its 1943 net income, the only remaining question is whether the Internal Revenue Code requires, or permits, the respondent to disallow a *deduction* for such liability by petitioner, in computing its excess profits tax for its calendar year 1943, and to allow, instead, such a deduction in 1944. There are several factors which we will consider separately in demonstrating that the proper answer to this question is no—a very *emphatic* no.

A. Local Law Is Controlling as to When a Local Tax "Accrues" for Purposes of a Deduction Under the Internal Revenue Code.

Section 23(c)(1) of the Internal Revenue Code provides that in computing net income there shall be allowed as deductions, taxes "paid or accrued" within the Federal taxable year (with the exception of certain types of taxes not here involved). It is firmly established that the question as to when local taxes "accrue," for purposes of this provision, must be determined by a reference to the provisions of the local taxing statute. See *Ma-*

gruder v. Supplee (1942), 316 U. S. 394, 62 S. Ct. 1162, 86 L. Ed. 1555. See, also, Randolph Paul, Selected Studies in Federal Taxation, Second Series (p. 23), where it is pointed out that the Federal statute, by "necessary implication," makes the state law controlling. The author says, further, that "It is *impossible* to determine when taxes accrue *except* by reference to the local acts imposing the taxes." (*Id.*, p. 24; emphasis added.)

While this principle is so incontrovertible that it should not even require the citation of authority in support thereof, it is submitted that, as pointed out to the Tax Court herein, a great deal of the apparent confusion in regard to the deduction allowed by Section 23(c) of the Internal Revenue Code for taxes paid or accrued, is the result of the persistent efforts of the Commissioner to set up his own standards as to who is liable and as to when liability accrues, rather than to follow the local law. In fairness to the Commissioner it would have to be conceded that sometimes this may be the result of the uncertain terms of the local taxing statutes. At other times, however, it is clear that in attempting to set up his own standards as to when taxes accrue the Commissioner is motivated by nothing better than a desire to simplify his administrative problems. Thus in *Commissioner v. LeRoy* (C. C. A. 2, (1945), 152 F. (2d) 936, in affirming a decision of the Tax Court allowing the purchaser of New York real property to deduct taxes paid by him and which, under the local law, became a lien after he acquired title to the property, the Court pointedly stated:

> In the brief for the petitioner we are told that inasmuch as the "transactions in New York City real estate are so numerous that the question is one of great importance," the Commissioner has brought this

> petition "in order to establish a clear, definite and workable rule for the federal administration of its income tax laws with respect to when New York City real estate taxes become a liability, are accruable, are deductible and by whom, when real property is sold or transferred." *The idea seems to be that there should be a federal rule establishing a uniform date determinative of the enumerated questions.* Cf. Estate of Rogers v. Commissioner, 320 U. S. 410, 64 S. Ct. 172, 88 L. Ed. 134; Lyeth v. Hoey, 305 U. S. 188, 59 S. Ct. 155, 83 L. Ed. 119, 119 A. L. R. 410; Burnet v. Harmel, 287 U. S. 103, 53 S. Ct. 74, 77 L. Ed. 199. These cases deal with instances in which the federal law and not the state law controls as to what is taxed. *But the present issue concerns the right to a deduction and taxes which may be deducted under §23(c)(1) of the Internal Revenue Code, 26 U. S. C. A. Int. Rev. Code, §23(c)(1), are often, as in this instance, laid by taxing authorities other than the federal government. Then what are taxes and who is the taxpayer depends upon local law. We see no escape from the resulting difficulties in administration.* (152 F. (2d) at p. 937.) (Emphasis added.)

Despite this cogent statement, however, the Tax Court has itself apparently been led into the error, in the present case, of attempting to establish some sort of universal rule for fixing the accrual date for *all state franchise taxes,* regardless of what the controlling local law may expressly provide as to the date on which the liability accrues and on which a lien therefor attaches. Thus, as

its final reason in support of its conclusion that the California franchise tax does *not* accrue on the date specified in the California statute as the time when liability for the tax shall accrue and the lien in support thereof shall attach to the real property of the taxpayer, the Tax Court says that the ruling of the Commissioner in I. T. 3646, C. B. 1944, p. 104—that the tax accrues at some indefinite time in the subsequent "taxable year"—is proper "and is consistent with the treatment accorded other state franchise taxes." [9 T. C. 134-135, R. 59.]

In support of this statement the Tax Court cites numerous other rulings by the Commissioner relating to *other* states. There is absolutely nothing in the Internal Revenue Code or in the decisions thereunder that warrants such complete disregard of the provisions of the *California* law on this subject. Here we are not concerned with the problem of when Illinois, or Kentucky, or Maryland, or Massachusetts, or Michigan, or Oklahoma, or Pennsylvania, or Tennessee, franchise taxes accrue—unless, of course, it can be shown that the statutes in those states contain *provisions in regard to the accrual of the tax and the lien in support thereof* which are similar to the provisions in this regard in the *California* statute. And an analysis of the rulings cited by the Tax Court [R. 59] discloses that none of the statutes there involved had accrual and lien provisions similar to those in the California Franchise Tax Act as amended in 1943. It does not afford any justification for the Tax Court's disregard of the provisions of the California Act to say that the result obtained, for Federal tax purposes, is "consistent with the treatment accorded other state franchise taxes."

B. Where There Is a Specific Accrual and Lien Date in the Local Law, That Date Controls as the Accrual Date for Federal Tax Purposes.

Of course, even if it is fully recognized that the provisions of the local taxing statute control as to when a tax, which is imposed thereby, accrues for purposes of a deduction under the Internal Revenue Code, the question remains as to how the "accrual" date is to be identified under the local law. Certain general principles will first be stated—in large part merely for purposes of contrast with the principles applicable to the facts herein—and cases in support of said principles applicable herein will then be discussed.

There has been considerable confusion in the rulings of respondent and in the decided cases in regard to just how the "accrual" date under the local law is to be identified. This may in large part be due to the fact that many taxing statutes do not *specify* either an accrual or a lien date. In such cases it is *necessary* to consider the nature and character of the tax, and the manner in which, and the period for which, it is imposed, and any other relevant factors in order to determine when *liability* arises. Even in such cases, however, it is *not* necessary that the tax should have been *assessed,* and the amount thereof finally *determined,* in order that it may be found that liability exists.

But the methods of determining the accrual date when the taxing statute does not contain any express designation of either an accrual or a lien date, are not applicable when the taxing statute does contain such express provisions. Manifestly, in the latter case the same problems

do not exist. The ultimate problem, of course, is to determine when *liability for the tax arises under the statute.*

The "liability" for a tax may be personal to the taxpayer, or it may be restricted to the specific property taxed or to the property subjected to the lien, or it may be both a personal liability and liability of property for the tax. Personal liability may, of course, arise without there being any lien. But the converse is never true. *If there is a lien, then there must be liability*—even though the liability may be limited to the property subject to the tax.

Accordingly, if the statute expressly provides for the *liability* to arise at an earlier date than the time specified for the *lien* to attach, that *earlier* date is when the tax *accrues* for purposes of the Internal Revenue Code. Likewise, even if the statute does not *specify* any accrual date, but from a consideration of all of the provisions of the statute it is apparent that *liability* has arisen prior to the date specified for the lien to attach, this earlier "date of liability" is when the tax "accrues."

Where, however, as here, the statute specifies a *single* date as the date when liability for the tax shall arise *and* the lien in support of such liability shall attach to all of the real property of the taxpayer, there can be no question but that *that* is the "accrual" date for purposes of determining when the deduction allowed by Section 23(c)(1) of the Internal Revenue Code must be taken.

There are innumerable cases which could be cited upon the foregoing propositions. It is sufficient, however, to refer to the leading Supreme Court decision, and to certain cases applying the same principle to California taxes.

> *Magruder v. Supplee* (1942), 316 U. S. 394, 62 S. Ct. 1162, 86 L. Ed. 1555;
>
> *California Sanitary Co., Ltd.* (1935), 32 B. T. A. 122;
>
> *Crown Zellerbach Corp.* (1941), 43 B. T. A. 541 (App. by Commissioner to C. C. A. 9, dismissed on stipulation, 6-29-42, 30 A. F. T. R. 1630).

These cases clearly establish, or recognize, the principle that taxes "accrue," for Federal income tax purposes, in the Federal taxable year in which falls the date on which personal liability for the tax arises, or in which a lien therefor attaches, whichever is earlier. They also show that this principle applies regardless of whether the tax in question is imposed *for* a taxable period which falls in a *subsequent* Federal taxable period, and regardless of whether, at such accrual date, the *amount* of the tax is due and payable, or is fixed and assessed, or is even *ascertainable* on the basis of facts then known. They thus provide the controlling principles for a decision herein.

The Tax Court, in its Opinion rendered in the present case, declined to follow the principles enunciated in the above-cited decisions. Its various reasons for rejecting said decisions will now be separately considered.

The first, and broadest, ground on which the Tax Court rejected said decisions was that they were distinguishable for the reason that they "* * * involve gen-

erally the question of *who* was liable for local property taxes *as between transferor and transferee.*" [9. T. C. 132; R. 53.] (Emphasis added.) It is true that the first two—but only the first two—of the cited cases (*Magruder v. Supplee* and *California Sanitary Company, Ltd., supra*), did involve the question of who was entitled to a deduction, for Federal tax purposes, of property taxes paid by a person who purchased the property and paid taxes which became a lien before the date of purchase. It is not apparent, however, why this prevents the principle established therein from being applicable to cases involving the deduction of taxes where no transfer of property is involved.

In the cases involving the right of a *purchaser* to deduct the property taxes paid by him, the courts, although ultimately deciding the question of *who was liable* for the taxes as between transferor and transferee, are also necessarily determining *when the liability for the tax accrued.* *If* liability for the tax accrued *prior* to the transfer of the property, then, manifestly, it was not the tax *of* the *transferee,* and so could not be deducted by him. However, it would seem to be clear that if the tax thus *accrues on the lien date* for purposes of determining *who* is entitled to a deduction therefor as between the seller and the purchaser, it must also *accrue on the lien date* for purposes of determining *when* it is deductible by a taxpayer on the accrual basis, even if no transfer of the property is involved.

In fact, it is squarely so held in the *Crown-Zellerbach* case, *supra,* notwithstanding the Tax Court has lumped that decision with *Magruder v. Supplee* and *California Sanitary Corp., Ltd., supra,* in distinguishing all of said

cases from the case at bar upon the bare ground that these cases "involve generally the question of who was liable for local property taxes as between transferor and transferee." The *Crown-Zellerbach* case involved, amongst other taxes, property taxes imposed by the State of California. These taxes became a lien on the first Monday in March but were levied *for,* and paid in, the state fiscal period commencing the following July first and ending on June 30 of the next calendar year. The taxpayer in that case kept its books of account on the basis of a fiscal year ending April 30, and used an accrual method of accounting. *The question presented to the Board was the proper year in which to deduct these taxes.*

The taxpayer, in the cited case, contended that it should be permitted to deduct in its fiscal year ended April 30, 1937, ten-twelfths of the California taxes which became a lien on the first Monday in March, 1936, and were *for* the State fiscal year July 1, 1936, to June 30, 1937—*because* ten-twelfths of that State fiscal period fell within said fiscal year of the taxpayer. In other words, the taxpayer's theory was, as is apparently the theory of the decision of the Tax Court herein, that taxes must be deducted in the taxpayer's accounting period in which falls the period *for* which the taxes are *imposed.*

The Commissioner, however, contended that taxes were required to be deducted in the year in which they *accrued,* and that they accrued in the taxpayer's fiscal year in which fell the *lien* date prescribed by the local law. Thus, in the cited case, his contention was that the taxpayer was required to *deduct* in its fiscal year ended April 30, 1937, the California taxes which became a lien on the first Monday in March, 1937, notwithstanding they

were *for* the period July 1, 1937, to June 30, 1938. *The Board upheld the Commissioner.* This is directly opposed, in principle, to the decision of the Tax Court in the case at bar.

Clearly, this first purported ground of distinguishing the "property tax cases," *i. e.,* upon the ground that they merely involve "the question of who was liable for local property taxes as between transferor and transferee," is without merit.

The Opinion of the Tax Court further attempts to distinguish the above-cited "property tax cases"—holding that property taxes accrue when a *lien* therefor attaches—upon the ground that "The nature and character of the franchise tax herein is essentially different from the property taxes involved in the above discussed cases." [9 T. C. 132; R. 54-55.] Of course, it is true that the two types of taxes differ in many respects. But the question is *not* whether the *taxes* involved in the cited cases are similar in their nature to those involved herein. Rather, it is whether the *statutory provisions identifying the date when "liability" for the taxes arises* are similar. For the ultimate question with which we are concerned—and this must be borne in mind at all times—is, When did *liability* arise?

If the taxing statute contains neither accrual nor lien date, then it is manifestly proper to determine when "liability" arises from all of the provisions of the statute, including a consideration of the nature and character of the tax and of the period *for* which the tax is imposed (*e. g., United States v. Anderson,* 269 U. S. 422, 46 S. Ct. 131, 70 L. Ed. 347). On the other hand, if the taxing statute contains a lien provision, then it is clear that

liability must have arisen, at the latest, by the date specified for the lien to attach. (*East Bay Municipal Utility Dist. v. Garrison, supra.*) However, even if there is a lien provision in the taxing statute, "liability" *may* arise at an *earlier* date than that specified for the lien to attach. Accordingly, if there is a lien provision but no express provision as to the date when "liability" arises, it is still proper to determine the latter date by a study of all of the provisions of the statute to determine whether "liability" in fact arose at an *earlier* date than that specified for the lien to attach (*e. g., S. E. Bernheimer,* 41 B. T. A. 249; aff'd, *per curiam* (C. C. A. 2), 121 F. (2d) 454).

When, however, as in the California Franchise Tax Act, the taxing statute expressly designates a single date as the date when liability for the tax accrues *and* when the lien in support of such liability attached to the property of the taxpayer, *that date is controlling* in determining when liability for the tax accrues for Federal income tax purposes. The same is necessarily true regardless of the "nature" of the tax. *Otherwise, full effect is not being given to the provisions of the controlling local law.* In such case there is no occasion for "interpretation" of the tax statute, to determine when "liability" arises for the tax imposed thereby—either by reference to the nature and character of the tax or by a consideration of any other provisions. When the provisions as to both liability and lien date are clear and unequivocal, *those provisions must be applied as they are written.* By hypothesis, there can be no *other* "state law" *on* the subject—and, as stated hereinabove, the Federal income tax law in regard to deductions for state taxes necessarily adopts by reference the state law as to the date when "liability" arises. What-

ever may be the propriety of looking to the "nature and character" of the tax to determine when "liability" arises under a statute which does *not* expressly designate a date when liability arises and when a lien in support thereof attaches, *this is not such a case.*

Manifestly, in disregarding the express provisions of the Franchise Tax Act designating the last day of the "income year" (here 1943) as the date when liability for the tax accrues and the lien in support thereof attaches to the real property of the taxpayer, and in deciding the case, instead, on the basis of its determination as to the "nature and character" of the franchise tax, the Tax Court, has in the language of the *Security Flour Mills* case, *supra,* "misconstrued the extent" of its powers. It is not within its power to "interpret" the local law to find a date when liability thereunder arises which is at variance with the clear and unequivocal provisions of the taxing statute. Nor is it within its power to "interpret" the Internal Revenue Code as requiring the accrual of taxes at some date *other* than the date when liability arises under the local law.

C. A Disregard of the Statutory Accrual and Lien Date Is Not Required by Reason of Any "Contingencies" as to Liability for, or Amount of, the Franchise Tax on the Last Day of the Income Year.

In discussing the nature of the franchise tax involved herein, the Tax Court further states that, under the terms of the Act, withdrawal or dissolution may relieve the taxpayer from taxation for the portion of the "taxable year" during which the franchise privilege is not exercised. [9 T. C. 133, R. 55.] Throughout its Opinion the Tax Court places great emphasis upon this alleged "contin-

gency" affecting the amount of the tax which may ultimately be required to be paid. It is submitted, however, that the Tax Court has misinterpreted the Act in regard to the existence and extent of the alleged "contingency" here involved and also has misconstrued its power to disallow a deduction upon the ground that the liability involved is subject to a "contingency." Each of these errors will be separately considered.

(1) *Extent of the Right, Under the California Franchise Tax Act, to a Refund in the Event of Dissolution During the "Taxable Year."*

The Tax Court states that if *no* business operations were carried on by the taxpayer in the "taxable" year "the tax would not be imposed." [9 T. C. 133, R. 55.] This clearly is not a correct interpretation of the California law. The Franchise Tax Act unequivocally provides that *every* corporation shall pay a *minimum* annual tax of twenty-five dollars. This is not only expressly stated at two separate points in the section of the Act imposing the tax (Act, sec. 4(3) and (5); Appendix, p. 4), but is repeated in the section providing for a refund of a proportionate part of the tax in the event of a withdrawal or dissolution before the end of the "taxable" year. (Act, sec. 13(k); Appendix p, 11.) See also the Franchise Tax Commissioner's interpretation in his Regulation Art. 29-1, paragraph 2. (Cal. C. T. par. 8-053, Appendix p. 18.)

Thus, under a correct interpretation of the California statute, the obligation to pay at least the amount of the minimum tax is inescapable in any case in which the taxpayer has failed to withdraw or dissolve *by the last day of the "income year."* Therefore, even if the question of

"liability" were to be determined by reference to provisions of the Act other than those designating the accrual and lien date, and even if the test as to whether that liability is "contingent" is whether there is a liability which the taxpayer is completely and irrevocably bound to satisfy, this test is met on December 31, 1943, under the law and the facts in the present case. Here, the *maximum* possible effect of the happening of the "contingency" in the California statute, viz., dissolution or withdrawal in 1944, would be to enable the corporation to reduce the *amount* of the tax based on the income of the "income year" which it would otherwise be required to pay.

(2) *Extent of Tax Court Power to Disallow a Tax Deduction as Being Only a Contingent Liability.*

It is not conceded, however, that the Tax Court has applied the proper *principle* as to "accruals," even if it were assumed, for the purpose of argument, that its interpretation of the *effect of the state law,* in the foregoing respect, were correct. The following argument is therefore presented as being equally applicable under *either* interpretation of the state law, *i. e.,* regardless of whether the "contingency" specified in the state law may result in a refund or abatement of the *entire* tax based upon the net income of the "income year," or may result in a refund or abatement of a part only of said tax.

It is true, of course, as a broad general principle, that "contingent liabilities" may not be deducted, for Federal income tax purposes. But, as in the case of most broad general principles, this must be applied with discernment, else its true purpose be distorted.

In the first place, it must be remembered that the question whether a liability is "contingent," in the sense which

is required before a deduction thereof may be disallowed, must be answered in the light of the events known or which reasonably should have been known as of the close of the Federal taxable year. Thus, in *Baltimore Transfer Co.,* 8 T. C. 1, the Tax Court,[9] in upholding a tax deduction in the amount accrued notwithstanding a subsequent reduction in the amount of the tax, succinctly stated:

> *The propriety of the accruals must be judged by the facts which petitioner knew or could reasonably be expected to know at the closing of its books for the taxable year* * * *. (8 T. C. at 7; emphasis added.)

Likewise in *Helvering v. Russian Finance & Construction Corp.* (C. C. A. 2, 1935), 77 F. (2d) 324, in upholding a deduction for royalties paid pursuant to a contract notwithstanding under the contract future events might cancel the liability, the Court said (77 F. (2d) at 327):

> * * * *The possibility that a present liability may subsequently be discharged by some condition subsequent does not prevent its accrual on the taxpayer's books. The test is whether a taxpayer is justified in entertaining a reasonable expectation that an expense will be incurred.* The taxpayer's liability became fixed upon delivery of the ore, and there then existed reasonable grounds to justify the taxpayer in believing that it would ultimately have to pay the $1,200,000. *A presently existing obligation, which the taxpayer has reasonable grounds to believe must eventually be fulfilled, is not uncertain or contingent in the sense that it may not be accrued.* See Automobile Ins. Co. v. Comm'r, 72 F. (2d) 265 (C. C. A. 2).

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[9]In an Opinion by the same Judge who wrote the Opinion in the case at bar. The Commissioner has acquiesced in the decision in the *Baltimore Transfer* case.

> The basis of the accrual system of accounting is that obligations incurred in the normal course of business will be discharged in due course. United States v. American Can Co., 280 U. S. 412, 50 S. Ct. 177, 74 L. Ed. 518. This is a necessary assumption. Conditions in the contract which would here have discharged the taxpayer from the liability it incurred upon delivery of the ore were not of a nature which would justify it in believing it would not have to pay the $1,200,000. The conditions never occurred, as the record disclosed, and the liability was in fact discharged by payment. *When books are kept on an accrual basis, a presently existing obligation which, in the normal course of events, the taxpayer is justified in believing he must fulfill, may be accrued.* The existence of an absolute liability is necessary; absolute certainty that it will be discharged by payment is not. Spring City Foundry Co. v. Comm'r, 292 U. S. 182, 54 S. Ct. 644, 645, 78 L. Ed. 1200.

By way of summary, then, the controlling principles in regard to accrual of "contingent" liabilities are as follows. If at the close of the Federal taxable year the very existence of "liability" is contingent upon the happening of events which have not yet occurred, accrual is *not* proper on the basis of the facts then known. Such a contingency is in the nature of a condition precedent to the liability. Accordingly, the non-occurrence of such a contingency leaves a status of "non-liability."

On the other hand, if at the close of the Federal taxable year "liability" does exist, but the question of how much, if any, of the liability may be required to be *satisfied* may be affected by future events, then accrual *is* proper *if* on the basis of the facts then known the taxpayer has

reasonable grounds to believe that his liability must eventually be fulfilled. The contingency in regard to the amount which will be required to be paid is, in such a case, in the nature of a condition subsequent. The propriety of the accrual must necessarily depend upon the likelihood of the condition occurring to *defeat* the status of *"liability"* which would otherwise exist.

Contrary to popular assumption, the payment of taxes is not always inevitable. There are many "contingencies" which may occur to reduce or discharge the liability without the necessity for payment in full. And in such cases, as in cases involving other types of obligations, the foregoing principles in regard to the effect of any "contingency" upon the propriety of an accrual of the obligation are applicable. In other words, if there is "liability" at the close of the Federal taxable year but there is a "contingency" in the nature of a condition subsequent which may reduce or defeat that liability, the propriety of accruing the liability depends upon the likelihood, under the facts known or which reasonably should have been known at the close of the taxable year, of the contingency occurring.

Thus, in *North Shore Bus Co.* (T. C. Memo. 1-27-43), P.-H. T. C. Memo. Dec. par. 43,041, C. C. H. Dec. 12,944-B (1 T. C. M. 493), it was held that the deduction of a New York City excise tax on gross income in the amount accrued on the taxpayer's books, was proper notwithstanding the liability was in fact subsequently settled for less than the amount accrued, the settlement being based on inability to pay rather than because the taxpayer was contesting liability for the tax. This decision was affirmed, on a petition for review by the Commissioner, but without discussion of the above point,

in *Commissioner v. North Shore Bus Co.* (C. C. A. 2, 1944), 143 F. (2d) 114. Similarly, in *Manhattan Soap* Co. (T. C. Memo. 3-22-44), P.-H. T. C. Memo. Dec. par. 44,092, C. C. H. Dec. 13,825(M) (3 T. C. M. 257), it was held that where Federal processing and excise taxes were not contested by the taxpayer but were settled under a compromise agreement for a smaller sum because of the taxpayer's financial condition the taxpayer was nevertheless entitled to a deduction of the full amount of the taxes, as accrued on its books.

In *Baltimore Transfer Co.,* 8 T. C. 1, a deduction was allowed for the amounts accrued and paid by taxpayer as its liability under the Maryland Unemployment Compensation Law, notwithstanding the taxpayer thereafter received a refund of a portion thereof pursuant to a new interpretation by the state board as to the correct tax rate applicable to taxpayer. The Court said (8 T. C. at pp. 6-7):

> * * * In our view, its obligation to pay the full amount deducted was sufficiently certain at the close of the taxable year to justify its accrual, whereas the right to receive the refund credit became final, if at all, in the following year.
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> * * * * * * * *
>
> It is apparent from the stipulated facts that petitioner neither denied nor questioned its liability for any portion of the accrued sums and had no reason prior to April 21, 1944, even to suspect that it might subsequently receive or be entitled to receive a refund or credit thereof. * * * The propriety of the accruals must be judged by the facts which peti-

tioner knew or could reasonably be expected to know at the closing of its books for the taxable year, and under the circumstances here we think that the accruals must be regarded as proper.

It is apparent, of course, that in none of the foregoing cases could the particular reason for the reduction in the amount of liability have been expressly recognized in the taxing statute. However, the cited cases clearly show that such "contingencies" do exist with respect to *all* taxes. The fact that they are not specified in the statute is of importance only as evidence that the "contingency" could not have been in the nature of a condition precedent to liability, but was in the nature of a condition subsequent. Accordingly, the accrual must stand in accordance with the facts as of that date, without regard to the effect of "contingencies" which every taxpayer knows *may* affect the amount which will be required to be paid in *discharge* of its liability.

It has also been held that deductions for taxes should be allowed in the year in which paid or accrued notwithstanding the taxing statute was subsequently held unconstitutional (*Charles F. Fawsett,* 30 B. T. A. 908; *Cartex Mills, Inc.,* 42 B. T. A. 894 (N. A., 1942-2 C. B., p. 22; G. C. M. 22404, C. B. 1940-2, p. 204),) unless, of course, the taxpayer is himself *contesting* the tax at the time he attempted to *accrue* it. (*Dixie Pine Products Co. v. Commissioner* (1944), 320 U. S. 516, 64 S. Ct. 364, 88 L. Ed. 270.) In the *Cartex Mills* case, *supra,* after stating that "It has been frequently said that taxation is a practical matter * * *," the Board said (p. 898):

> * * * To conclude, in an interpretation of the revenue acts, that substantial amounts paid pursuant to a taxing statute, vigorously enforced by the

> sovereign and not declared unconstitutional until a later year, are not "taxes paid or accrued within the taxable year" within the meaning of the revenue act would be, by way of understatement, highly impractical.

To the same effect see I. T. 3149, C. B. 1938-1, p. 124, holding that taxpayers who did not contest the validity of the Carriers Taxing Act of 1935, and who accrued liability therefor on their books, were entitled to a deduction for this accrued liability in the year of accrual notwithstanding actual liability was subsequently extinguished by litigation conducted by other taxpayers.

Nor is any different result reached when the tax for which liability has attached is subject to reduction in amount by reason of the occurrence of some subsequent event which is expressly identified in the taxing statute. Thus, in *W. J. Bush & Co., Inc.* (T. C. Memo., 1-8-45), P.-H. T. C. Memo. Dec. par. 45,054, C. C. H. Dec. 14,390(M) (4 T. C. M. 194), the Court held, upon the concession of the point by the Commissioner, that a taxpayer on the accrual basis was entitled to deduct the full amount of British Excess Profits Taxes notwithstanding *the tax law* provided for the refund of a percentage thereof, *upon certain contingencies,* after the termination of hostilities in World War II.

Particularly enlightening on the point under discussion are the decisions in regard to the effect of the contingent nature of the Federal capital stock tax, imposed (prior to the repeal of this tax by Section 205 of the Revenue Act of 1945) by Section 1200 of the Internal Revenue Code. That tax was an excise tax upon corporations, based upon the "declared value" of their capital stock.

The tax was *for* "each year ending June 30." (Sec. 1200-(a), I. R. C.) Returns were not required to be made, however, until "within one month after the close of the year with respect to which such tax is imposed." (Sec. 1203(b) (1), I. R. C.) The corporation was required only to state *in the return* the value which it declared upon its capital stock "as of the close of its last income-tax taxable year ending with or prior to the close of the capital stock tax taxable year * * *." (Sec. 1202(a), I. R. C.)

Thus, in July, 1940, a calendar year corporation would file its capital stock tax return for the capital stock tax taxable year ended June 30, 1940, declaring therein the "value" of its capital stock as of December 31, 1939. Manifestly, at all times up to the time of filing the return in July, 1940, it was entirely within the control of the taxpayer whether it would have to pay *any* capital stock tax. And yet, under the decisions of the Tax Court hereinafter cited, such capital stock tax was accruable as of July 1, 1939.

True, if the taxpayer didn't fix an adequate value to its capital stock for capital stock tax purposes, it would run the risk of becoming liable for a declared value excess profits tax at an even higher rate (see I. R. C. Secs. 600-605, prior to repeal by Revenue Act of 1945). But this would not be even a *practical* (let alone a legal) compulsion if the taxpayer, on a calendar year basis, *dissolved* before the commencement of the taxable year for which the capital stock in question is the measure of liability for the declared value excess profits tax. In such case the taxpayer could, with complete impunity, file a capital stock tax return showing *no* value to its capital stock and thus wipe out its entire capital stock tax liability for the pre-

ceding capital stock tax year. This would not result in any greater declared value excess profits tax liability, because the corporation would not be in business during the year for which the capital stock tax declaration is the preliminary measure of liability for the declared value excess profits tax.

For example, if a corporation was on a calendar year basis and dissolved on November 30, 1943, it would have been required to file a capital stock tax return for the capital stock tax taxable year ending June 30, 1944. However, since there would be no income during the income tax taxable year ending December 31, 1944, on which the "penalty" declared value excess profits tax might apply, the taxpayer could safely, in its capital stock tax return for the capital stock tax taxable year ending June 30, 1944, show no value and no tax.

Notwithstanding such contingency with respect to the capital stock tax liability throughout the capital stock tax taxable year, it is uniformly held (except where the taxpayer, by the accounting method adopted by him and consistently followed, accrued the capital stock tax monthly, see *Atlantic Coast Line R. Co.*, 4 T. C. 140), that that tax accrues on the first day of the capital stock tax year for which it is imposed. See *Budd International Corp.* (1941), 45 B. T. A. 737 (reversed on another point in *Budd International Corp. v. Commissioner* (C. C. A. 3, 1944), 143 F. (2d) 784), where the taxpayer in fact made several changes in the values reported for capital stock tax purposes, but it was held that liability nevertheless accrued on the first day of each capital stock tax year. See, also *Louisiana Delta Hardwood Lbr. Co., Inc.*, 7 T. C. 994, holding (in an opinion written by the Trial Judge herein) that the capital stock tax for the capital

stock tax year July 1, 1941, to June 30, 1942, accrued on July 1, 1941 notwithstanding the entire liability might have been eliminated by the taxpayer as late as July, 1942, by filing a return which declared no value for its capital stock.

Even the Commissioner has not seen fit to contend that the contingencies with respect to the capital stock tax render liability therefor so uncertain as to prevent accrual of the tax on the first day of the capital stock tax taxable year. In this connection see *Atlantic Coast Line R. Co., supra,* where the Court said with reference to the proper accrual date for the Federal capital stock tax:

> * * * Neither party contends that the amount of the tax, dependent as it is upon a future declaration of value and possible change in rate, is so uncertain at the beginning of the capital stock tax year that its accrual should be postponed to the end, and this would be inconsistent with what we held in *Budd International Corporation,* 45 B. T. A. 737; reversed other grounds (C. C. A., 3d Cir.), 143 Fed. (2d) 784. (4 T. C. 140, 150.)

The applicability to the facts herein, of the foregoing principles in regard to the accrual of taxes which are subject to certain "contingencies" as to amount or as to liability, is self-evident. In the first place, it is clear that under the express terms of the California Franchise Tax Act there *is* "liability" on the taxpayer as of the last day of the income year. This is the necessary effect of both the express provision in the Act as to *accrual* on that date and the express provision establishing the *lien* on that date. As demonstrated hereinabove, *there cannot be a lien without "liability."*

Thus, any "contingencies" which may occur—regardless of whether they affect the entire "liability" or merely reduce the tax to a lesser *amount*—are necessarily in the nature of *conditions subsequent.* They cannot, under the unequivocal terms of the Act, affect the existence of "liability" *at the close of the income year.*

Necessarily, then, the only remaining question is whether, under the facts known to petitioner, or which could reasonably be expected to be known to it, at the close of its state "income year," *i. e.,* its Federal taxable year 1943, it was proper for petitioner to have accrued upon its books as of December 31, 1943, its liability for the full amount of the franchise tax based upon its 1943 net income.

The answer to this question—being based, as it must, upon reasonable probabilities and practical expectancies rather than according to theoretical and legalistic possibilities—is crystal clear: petitioner did properly accrue, on December 31, 1943, its *liability* for the full amount of the franchise tax which it knew it would be required to pay, and which it did pay, in 1944 in the normal course of events as a going business. The fact that, legally, it *could* dissolve and thereby affect the *amount* of such liability which it would have to satisfy, not only did not affect the existence of "liability," but was such a remote contingency as to have no practical relationship in any way to its accrual on its books of liability for the entire amount of the tax on December 31, 1943.

Thus, the record shows that such an event—dissolution—not only was not reasonably likely to occur, but *did not* occur, with respect to petitioner. It has been *admitted by the pleadings* that at no time material hereto did the peti-

tioner have pending any negotiations for the possible sale of its Biltmore Hotel property, or contemplate dissolution or liquidation. In other words, as of December 31, 1943, it had no intention of liquidating or dissolving, or of disposing of any of its income-producing properties, in 1944, or at all. It intended to continue with the normal operation of its business in 1944, as in 1943. Necessarily, then, it must have intended to pay, in 1944, the full amount of the California franchise tax for 1944 based upon its net income in 1943, without abatement or reduction in any part on account of any dissolution of petitioner or at all.

Furthermore, petitioner did in fact operate throughout 1944, commencing with the first instant in that year, in the same manner in which it had operated in 1943, up to the last instant in that year. And it continued so to operate in succeeding years and is still so operating. It *paid,* in 1944, the full amount of the California franchise tax for 1944 based upon its net income in 1943, without abatement or reduction in any part on account of any dissolution of taxpayer or at all. It is admitted by the pleadings that petitioner has never at any time disputed its liability for the whole or any part of the California franchise tax based on its 1943 income, has never filed any claim for refund or credit with respect thereto, and has never had, and does not now have, any intention of filing any such claim.

In short, in the light of the facts as of the close of the "income year" (1943) there was not even a *remote* possibility of the petitioner not being required to pay in full the liability which the California Franchise Tax Act imposed upon it as of December 31, 1943. As heretofore stated, then, it would have been utterly unreasonable for

it to have failed to accrue the liability which all of the facts then known indisputably showed to exist under the controlling local law. And subsequent events have only borne out petitioner's then appraisal of the facts. Under these circumstances, there was not, on December 31, 1943, any such contingency as to petitioner's "liability" for the franchise tax based on its 1943 net income as would justify the refusal of respondent, and of the Tax Court, to allow a deduction, in petitioner's 1943 excess profits tax return, for the full amount of the tax so accrued.

D. A Disregard of the Statutory Accrual and Lien Date Is Not Required by Reason of the Fact That the Tax Is *for* a Subsequent Period.

The Tax Court, in its decision herein, apparently was of the view that taxes—franchise taxes, at least—*cannot* be accrued in a year other than the year *for* which they are imposed.

Thus, the Court said, "* * * the tax being for the privilege of doing business in the taxable year, the *liability* therefor arises only with and from the exercise of such privilege." [9 T. C. 133, R. 55; emphasis added.] From a consideration of the entire Opinion, however, it is apparent that this statement was made only because the Court had concluded that the provisions of the Franchise Tax Act specifying the date when liability should accrue and when the lien therefor should attach to the real property of the taxpayer were to be disregarded. Manifestly, the Court could not have made the quoted statement if effect had been given to the accrual and lien provisions of the local law.

Also, in support of the proposition that the tax must be accrued in the year *for* which it is imposed, the Tax Court cited the cases of *United States v. Anderson, et al.*, 269 U. S. 422, 46 S. Ct. 131, 70 L. Ed. 347; *Petaluma & Santa Rosa R. R. Co.,* 11 B. T. A. 541; *H. H. Brown Co.,* 8 B. T. A. 112; and *Durst Productions Corporation,* 8 T. C. 1326. Apparently these cases, too, were cited on the basis of the fundamental error of the Tax Court herein, in assuming that the express accrual and lien provisions of the California Franchise Tax Act were of no significance in determining the proper accrual date for Federal tax purposes. Clearly, the cited cases would *not support* the proposition that a tax must be accrued in the year *for* which it is imposed *if* the taxing statute expressly provides that liability shall accrue, and a lien in support thereof shall attach to the property of the taxpayer, at an *earlier* date.

United States v. Anderson, supra, involved the accrual and deduction of the Federal tax on income from munitions manufacture and sale. Apparently there was not any express provision in the taxing statute either identifying the time when liability for the tax arose or establishing a lien in support of the tax liability. The taxpayer set up a reserve for the tax as of the end of the income year, but nevertheless contended that it should not be required to deduct the tax until the following year because it was neither assessed nor due and payable until then. The United States contended that the tax accrued on the last day of the income year, and was therefore re-

quired to be deducted in that year. The Supreme Court, in holding for the United States, said (46 S. Ct. 131, 134):

> Only a word need be said with reference to the contention that the tax upon munitions manufactured and sold in 1916 did not accrue until 1917. In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax all of the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.

The language as quoted by the Tax Court herein from the opinion in the *Anderson* case was not used in the portion of the opinion relating to the specific question of the proper *time* to accrue taxes. Rather, it was used in connection with the Supreme Court's rejection of the taxpayer's preliminary proposition that the accrual provisions of the Revenue Act of 1916 *were not intended to be applied* to taxes at all.

Petaluma & Santa Rosa R. R. Co., supra, cited by the Tax Court, is a "property tax" case. The tax there involved was imposed on corporate property on the first Monday in March, but the amount of the tax was measured by the gross receipts of the preceding year instead of on an *ad valorem* basis. Thus, in *principle,* the case does not differ from the *California Sanitary Co.* case (32 B. T. A. 122) and the *Crown-Zellerbach Corp.* case (43 B. T. A. 541), cited by petitioner. Yet the Tax Court *distinguished those cases* upon the ground that they were mere "property tax" cases, saying [9 T. C. 132, R. 54]:

> * * * None of these cases, in our opinion, is controlling of the question at hand because these cases

> involve property taxes, the personal liability for which arises by virtue of ownership at a specified time.

The same could, of course, be said of the *Petaluma* case, *supra,* cited by the Tax Court.

In citing the *Petaluma* case as it did, however, the Tax Court apparently was of the view that the proper accrual date for *all* taxes *measured by income*—whether excise or property taxes—must be determined according to a universal rule, viz., according to the year *for* which the tax is imposed. The *Petaluma* case is not authority for any such proposition. All that the Board there held, or was required to hold, was that the tax there in question, which was based upon the ownership of the property on the first Monday in March, 1921, and which became a *lien* on that date, did *not* accrue in *1920* notwithstanding the tax was *measured by* the taxpayer's income for that earlier year. Manifestly, this does *not* require the conclusion that the *same* holding would, or should, be made where the taxing statute expressly provides that the tax shall accrue and become a lien on the last day of the year the income of which is the measure for the tax. Yet that is in effect the proposition which the Tax Court decided herein—purportedly on the authority, in part, of said *Petaluma* case. The cited case does not provide any support for the decision herein. If anything, it is in support of the petitioner's position that the statutory accrual and *lien* date is controlling.

H. H. Brown Co., supra, cited by the Tax Court herein, involved a deduction for the Massachusetts corporation excise tax in the taxpayer's Federal taxable year ended June 30, 1922. As disclosed in the opinion of the Board of Tax Appeals, the Massachusetts statute imposed what

the Massachusetts Supreme Court had denominated "an excise for the commodity of carrying on business." (See 8 B. T. A. 112, 116.) The tax was assessed as of April first of the taxable year, and was based on "* * * the excess of the fair cash value on that date of the shares of capital stock over certain deductions plus the net income of the corporation as shown by its last Federal income-tax return." (*Id.* p. 116.)

The Board determined, from decisions of the Massachusetts court, that the tax in question was an *obligation* of the corporation on and after April 1, 1922. (*Id.* p. 117.) The Commissioner apparently contended that the tax was not accruable or deductible in the taxable period ended June 30, 1922, however, because the exact amount thereof had not yet been ascertained and the tax was not yet due and payable. The Board held that these latter factors were immaterial where there was an *obligation* for the tax in the year in which the taxpayer sought to take the deduction. It was in this setting that the Board said, as quoted in the Tax Court Opinion herein [9 T. C. 134, R. 58]:

> The basic idea under the accrual system of accounting is that the books shall immediately reflect obligations and expenses definitely incurred and income definitely earned without regard to whether payment has been made or whether payment is due. Expenses incurred in the operations for a particular year are properly accrued in the accounts for that year, although payment may not be due until the following year.

When this quoted language is read in the light of the decision which was rendered and in the full context in which it was written, it is clear that there is nothing in

such language or in the decision which supports or was intended to support the conclusion that taxes *must* be accrued and deducted in the year *for* which they are paid *regardless* of any provision in the taxing statute designating a date when liability accrues and a lien in support thereof attaches. On the contrary, the Board clearly held that taxes accrue when there is an "obligation" therefor. (And it is interesting to note that it rendered the *same* decision, and on the basis of the same reasoning, in regard to *both* property taxes and the franchise tax in question. See 8 B. T. A. 112, 117.) It is reasonable to conclude, then, that if the statute there before the Board had expressly designated an accrual and lien date, and thus established the "obligation" as of that date, the Board would have held that the taxes accrued at that date for purposes of a Federal income tax deduction.

It is not apparent why *Durst Productions Corporation, supra,* is cited by the Tax Court herein in conection with its discussion of the alleged requirement that the tax be deducted in the period *for* which it was imposed, unless it was because the Opinion in the cited case relies largely upon the decision in the *Anderson* case, *supra,* which the Tax Court also cites herein. However, since the *Durst* case is so cited by the Tax Court herein, it will be discussed at the present point in regard to all of its implications, regardless of the fact that some of the principles involved have already been separately treated in this brief, as it is difficult to consider the decision except in its entirety.

The *Durst* case held that the New York State franchise tax imposed under the law as amended on March 31, 1944, and based on the taxpayer's income for its fiscal period ended May 31, 1944, was deductible in the taxpayer's

Federal excess profits tax return for said fiscal period. In so holding the Court stated [9 T. C. 134, R. 58]:

> The tax being calculated on the amount of earnings for the year in issue its charge against those earnings seems to accord with the theory of accrual.

The Tax Court quoted this language with approval in its Opinion herein. There is nothing either in the result obtained in the cited case or in the quoted language, which supports the conclusion reached in the present case, and in connection with which the *Durst* case was cited—that every franchise tax must be accrued only in the year *for* which the tax is imposed. In fact, the above-quoted portion of the Opinion certainly can be reasonably read as being strictly applicable in *favor* of petitioner herein. But petitioner is aware of the danger of placing too much emphasis upon language thus separated from the text in which it was used. It is therefore desirable to consider the cited case in more detail to see if it can be ascertained *why* the Court reached the decision which it did and to see whether these *reasons* have any applicability herein.

As is pointed out in a recent article devoted entirely to a discussion of the *Durst* case (Gerhard J. Mayer, "The Accrual Date of the New York State Franchise Tax," Taxes, Vol. 26, No. 1, p. 43), "Comment on the court's principal argument [the effect of the local law upon the accrual date] is rendered difficult by its failure to point to the specific provision of local law which it considered as decisive." It is clear, however, that the decision was rendered upon the theory that the local taxing statute there in question was strictly comparable to that which was involved in the *Anderson* case, *supra*. Accordingly, it must have been assumed in the *Durst* case that the statute there involved imposed a tax which was *for* the

same period as that *on the income of which* the tax was based. And the Tax Court herein expressly states that the tax in the *Durst* case is measured by the net income "of the year *for* which the tax is imposed * * *." [9 T. C. 134, R. 58; emphasis added.]

But even if this is a correct interpretation of the *Durst* case, and of the statute there involved, then the full effect of the decision would be that where a franchise tax is based on the income *of* the year *for* which the tax is imposed, it accrues on the last day of such year. In such a view of the case, it is clear that the Court does not even purport to consider what would be the proper accrual date when the tax is *for* a different period than the income year, and when, as here, the taxing statute expressly designates the last day of the income year as the date when liability for the tax shall accrue and the lien in support thereof shall attach.

It is not disclosed by the Opinion in the *Durst* case whether the New York statute there in question contained any express provision designating the accrual and lien date. All that is said is that "Since computation of the franchise tax was fixed by the income of fiscal 1944, and the obligation to pay was thereupon inescapable, we think the tax was accruable on the last minute of that day." There is no indication as to the basis for this statement, *i. e.,* whether it is based on certain express provisions of the statute or on a mere interpretation of the effect of its provisions in the aggregate. The Tax Court herein, however, stated that a *lien is* provided for in the tax statute involved in the *Durst* case and that this lien attached in a taxable year subsequent to that on the income of which the tax was based. [9 T. C. 134, R. 58.] As noted, this does not appear anywhere in the opinion in the cited case.

Accepting as true, however, the statement that the New York statute provided for a lien attaching in a *subsequent* period, would not make the cited case an authority in support of the proposition that the Tax Court is free to disregard the lien date in any and all franchise tax cases, in favor of the rule that the tax must *always* be accrued in the year *for* which it is imposed. The *Durst* case is clearly both supportable, and yet distinguishable from the case at bar, upon the basis of the following reasoning.

A lien is merely one of the indicia of "liability." It is just as proper to disregard the *lien* date specified in the statute in favor of an *earlier* accrual date (see *S. E. Bernheimer, supra*), as it is to disregard any other indicia of liability (as, for example, the date when the tax is due and payable, as in the *Anderson* case), in favor of an earlier date, *if* such *earlier* date is supported, expressly or by necessary implication, by other provisions of the taxing statute. *(S. E. Bernheimer, supra; United States v. Anderson, supra.)* For, as heretofore stated, it is clear that there may be *liability without there being a lien.* But since there can *not* be a *lien* without there being a *liability* in support of which the lien is granted, it can never be proper to disregard the lien date specified in the statute in favor of a *later* accrual date. Clearly, there could not be any valid *express* provision for a liability to arise only at a time *subsequent* to the time when the lien attaches. And it does not lie within the power of the Tax Court to read into the controlling local law a provision which would be invalid if expressly made a part of the statute.

Regardless of how the *Durst* decision is analyzed, it is clear that it does not, either on its face or on the basis of any assumptions that can reasonably be indulged in to

supplement the Opinion therein, require or support the decision herein.

Thus, the cited cases either involve taxes for which no statutory accrual or lien date was prescribed, or if there was a lien date, the decision is consistent with the principle that the statutory accrual or lien date is controlling, whichever is earlier. No authority has been found for the proposition that taxes which, under unequivocal provisions of the local tax law, accrue and become a lien in one taxable year of the taxpayer, may be shifted by the Commissioner to a later taxable year merely because that is the year *for* which the tax is imposed. Certainly, no case cited in the Opinion of the Tax Court so holds; and that Court apparently recognized this, for as noted, its whole discussion is based upon the false premise that the accrual and lien provisions of the California Franchise Tax Act may be disregarded as having "no significance" except for purposes of establishing the state's "priority."

E. A Disregard of the Statutory Accrual and Lien Date Is Not Required by the Principle That Deductions Must "Properly Reflect" Petitioner's Net Income.

It is interesting to note that it is only in connection with the discussion of the proper time for taking the deduction for the franchise tax *as a business expense,* that any reference is made in the Opinion of the Tax Court to the proper accrual date as being affected by the requirement that the accrual "properly reflect" petitioner's net income. It is merely declared, without consideration of any authorities, that the tax was "* * * an expense which must necessarily be taken into account in the tax year 1944 in order properly to reflect petitioner's net income in that year." [9 T. C. 133; R. 56.] This is clearly erroneous.

The case of *Security Flour Mills v. Commissioner* (1944), 341 U. S. 381, 64 S. Ct. 596, 88 L. Ed. 725, establishes beyond controversy that the Commissioner may *not* take deductions out of the year in which they in fact *legally accrued* and put them in some other year, upon the alleged ground that this is necessary in order "to clearly reflect income." It is noteworthy that the Opinion of the Tax Court herein does not even refer to the *Security Flour Mills* case, even though that case was called to the attention of the Tax Court by the petitioner herein.

On this matter of properly reflecting income, the decision in the *Crown-Zellerbach* case, *supra,* is also of interest. In that case, in rejecting the contention of the taxpayer that these taxes should be accrued only in the proportion that they were *for* a tax period included in the taxpayer's fiscal year, and in holding that the taxes there involved accrued—and were deductible—*when they became a lien,* the Board necessarily held that the method of accounting so approved by it *clearly reflected income.*

In the present case, under the unequivocal provisions of the state law, the tax accrued and became a lien on December 31, 1943. Under the principle established in the *Security Flour Mills* case, the Commissioner is not, under such facts, entitled to shift the accrual date to some undesignated time in 1944, under the guise of properly reflecting petitioner's net income. Again, it is clear that the Tax Court has erred by reason of its complete disregard of the provisions of the local tax statute specifically establishing the date of accrual of, and of the lien for, the tax.

Conclusion.

In conclusion, then, it is clear that all of the decisions or rulings bearing upon the issue of the proper time for the accrual of taxes, recognize that the basic question the answer to which controls the decision is, When did "liability" for the tax arise? Clearly, the answer to that question in the present case is that liability arose on the last day of the "income year," in accordance with the express and unequivocal provisions of the Franchise Tax Act that liability for the tax shall accrue and a lien in support thereof shall attach to the real property of the taxpayer on that date. Any other answer would not give full effect to the controlling local law.

The petition for review should therefore be granted, and the decision of the Tax Court reversed and the case remanded to the Tax Court with instructions to enter judgment for the petitioner consistent with Section 322 (d) of the Internal Revenue Code.

Respectfully submitted,

JOSEPH D. BRADY,
JOHN O. PAULSTON,
Counsel for Petitioner.

Los Angeles, California, February 2, 1948.

APPENDIX.

Statutes, Regulations and Rulings Involved.

Internal Revenue Code:

Section 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * * * *

(c) *Taxes Generally.*—

(1) *Allowance in General.*—Taxes paid or accrued within the taxable year, * * *

Section 41. General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

Section 43. Period for which Deductions and Credits Taken.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

Section 48. Definitions.

When used in this chapter—

* * * * * * * * *

(c) "Paid or Incurred," "Paid or Accrued."—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

Regulations 111:

Sec. 29.23(c)-1. Taxes.—(a) *In general.*—Subject to the exceptions stated in this section and sections 29.23(c)-2 and 29.23(c)-3, taxes imposed by the United States, any state or territory, or political subdivision of either, possessions of the United States, or foreign countries, are deductible from gross income for the year in which paid or accrued (see section 43). * * *

Sec. 29.41-1. Computation of net income.— * * * The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

Sec. 29.41-2. Bases of computation and changes in accounting methods.—Approved standard methods of ac-

counting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. * * *

Sec. 29.41-3. Methods of accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. * * *

Sec. 29.43-1. "Paid or incurred" and "paid or accrued."—(a) The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48(c).) The deductions and credits provided for in chapter 1 (other than the dividends paid credit provided in section 27) must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. * * *

Section 29.43-2. When charges deductible.—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year

cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. * * *

California Bank and Corporation Tax Act (*Calif. Stats. 1929, p. 19*) *as amended to and in effect on December 31, 1943:*

Sec. 4. Tax on Corporations. * * *

* * * * * * * * *

(3) *Tax on Other Corporations.* With the exception of financial corporations, every corporation doing business within the limits of this State and not expressly exempted from taxation by the provisions of the Constitution of this State or by this act, shall annually pay to the State, for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income, to be computed, in the manner hereinafter provided, at the rate of 4 per centum upon the basis of its net income for the next preceding fiscal or calendar year. In any event, each such corporation shall pay annually to the State, for the said privilege, a minimum tax of twenty-five dollars ($25).

* * * * * * * * *

(5) *Minimum Tax.* Every corporation not otherwise taxed in pursuance of this section and not expressly exempted by the provisions of this act or the Constitution of this State shall pay annually to the State a tax of twenty-five dollars ($25).

* * * * * * * * *

(7) *Accrual Date.* Taxes under this section and under Sections 1 and 2 of this act shall accrue on the last day of the "income year," as defined in Section 11 hereof.

Tax in Lieu of Other Taxes on General Franchises. Assessment of Special Franchises. Taxes under this section shall be in lieu of all ad valorem taxes and assessments of every kind and nature upon the general corporate franchises of the corporations taxable hereunder but shall not be in lieu of any taxes or assessments upon special franchises owned, held or used by said corporations. * * *

Sec. 5. Definitions. The term "corporation," as herein used, shall include every corporation, other than a bank or banking association, and other than those expressly exempted from the tax by the provisions of this act or the Constitution of the State of California.

* * * * * * * * *

The term "doing business," as herein used, means actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.

Sec. 11. Definitions. (a) The term "income year," as herein used, means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed herein. "Income year" includes, in the case of a return made for a fractional part of a year, the period for which such return is made.

(b) The term "taxable year," as herein used, means the calendar year, or the fiscal year ending during such calendar year, for which the tax is payable. A "taxable year" may constitute a period of 12 months or of less duration.

* * * * * * * * *

Sec. 13. Returns of Taxpayers. Computation of Tax in Case of Commencing Banks and Corporations, Dissolutions, Withdrawals, Cessation of Business and Corporate Reorganizations. (a) *Returns of Taxpayers.* Every bank and corporation subject to the tax imposed by this act shall, within two months and 15 days after the close of its income year, transmit to the commissioner a return in a form prescribed by him, specifying, for the income year, all such facts as he may by rule, or otherwise, require in order to carry out the provisions of this act. Any return filed under the provisions of the Corporation Income Tax Act, which discloses the net income for any period, shall likewise constitute a return filed for the same period under this act, if the corporation should have filed a return under this act.

In the event that taxes, interest and penalties have been or shall be assessed against, paid by or collected from a corporation under this act, which assessment, payment or collection should have been made under the Corporation Income Tax Act, such taxes, interest and penalties shall be considered as having been assessed, paid or collected under the Corporation Income Tax Act as of the date or dates they were made.

(b) *Commencing Corporation to Prepay Minimum Tax.* A corporation which incorporates or organizes under the laws of this State or qualifies to do business in this State, after the effective date of this act, shall thereupon prepay the minimum tax hereunder, which prepayment must be made before the corporation files with the Secretary of State its articles of incorporation or duly certified copy thereof as the case may be.

(c) *Computation of Tax of Commencing Corporations.* If a bank or a corporation commences to do business in this State during its first taxable year its tax for that year shall be adjusted upon the basis of the net income received during that taxable year, at the rate applicable to that year, a credit being allowed for the prepayment of the minimum tax. The return for the first taxable year, which shall be filed within two months and 15 days after the close of that year, shall also, in accordance with Sections 23 to 26, inclusive, be the basis for the tax of said bank or corporation for its second taxable year, if its first taxable year is a period of 12 months. In every case in which the first taxable year of a bank or corporation constitutes a period of less than 12 months, or in which a bank or corporation does business for a period of less than 12 months during its first taxable year, said bank or corporation shall pay as a prepayment of the tax for its second taxable year a tax based on the income for the first taxable year computed under the law and at the rate applicable to the second taxable year, the same to be due and payable at the same times and in the same manner as if that amount were the entire amount of its tax for that year; and upon the filing of its tax return within two months and 15 days after the close of the second taxable year it shall pay a tax for said year, at the rate applicable to that year, based upon its net income received during that year, allowing a credit for the prepayment; but in no event shall the tax for the second taxable year be less than the amount of the prepayment for that year, and said return for its second taxable year shall also, in accordance with Sections 23 to 26, inclusive, be the basis for the tax of said bank or corporation for its third taxable year.

(d) *Computation of Tax of Corporation Commencing to Do Business for First Time in Taxable Year Other Than Year of Incorporation.* When any bank or corporation commences to do business in this State for the first time in any taxable year other than the year of incorporation or qualification, its tax for that taxable year and for the succeeding taxable year shall be computed in accordance with the provisions of subdivision (c) of this section relative to first and second taxable years, a credit being allowed for any tax payable under subdivision (5) of Section 4 hereof, for the year in which it commences to do business.

(e) *Due Date of Adjusted Tax.* The adjusted tax, as provided in subdivisions (c) and (d) of this section, for any taxable year in excess of the prepayment for that year, shall be due and payable in one amount on or before the fifteenth day of the third month following the close of that taxable year, or on or before the expiration of the period of extension where an extension has been granted by the commissioner under the provisions of Section 15 of this act, and, if not so paid, interest shall be added thereto in the manner and at the rate or rates provided in Section 24 of this act.

(f) *Apportionment of Income or Deductions Reported on Deferred Basis.* In the case of a bank or corporation taxable in the manner provided in subdivisions (c) and (d) of this section, reporting income from any source on a deferred basis, the commissioner is authorized to distribute or apportion such income, or deductions applicable thereto, if he determines that such distribution or apportionment is necessary in order to prevent avoidance of taxes or clearly to reflect the income of such bank or corporation.

(g) *Provisions for Tax of Commencing Corporations Not Applicable to Reorganized Corporations.* Subsections (c), (d), and (e) of this section shall not apply to a bank or a corporation which commences to do business in this State, pursuant to a reorganization of a bank or corporation as defined in subsection (j) of this section.

(h) *Tax Imposed on Transferee in Reorganization.* (1) Where, pursuant to a reorganization, all or a substantial portion of the business or property of a bank or corporation, a party to the reorganization is transferred to another bank or corporation, a party to the reorganization: (A) The net income of the transferor from the business or property so transferred to any bank or corporation for the taxable year in which the transfer occurs, shall be included in the measure of the tax on the transferee for the taxable year succeeding the taxable year in which the transfer occurs if the taxable year of the transferee in which the transfer occurs ends at the same time as or before the time the taxable year of the transferor in which the transfer occurs ends. Income of the transferor so included in the measure of the tax on the transferee shall be considered the income of the transferee for the purposes of this act.

(B) If the taxable year of the transferee in which the transfer occurs ends after the taxable year of the transferor in which the transfer occurs ends, the transferee shall, within two months and 15 days after the close of the taxable year of the transferor in which the transfer occurs, file a return disclosing the net income of the transferor from the business or property transferred for the taxable year in which the transfer occurs, and pay a tax measured by such income.

(2) If, at the time of any of the transfers referred to in the preceding subdivision (1), the transferor has not become subject to a tax measured by its income for the taxable year preceding the taxable year in which the transfer occurs, the transferee shall within two months and 15 days after the close of the month in which the transfer occurs file a return disclosing the net income of the transferor for such preceding year and pay a tax measured by such income.

(3) Whenever under this subsection the transferee is required to pay a tax measured by the income of the transferor, the rate of tax applicable to the transferee shall apply.

(4) The transferee shall, pursuant to the provisions of Sections 4 and 26 of this act, be entitled to the same offset against any tax imposed on it measured by the income of the transferor for taxes on the business or property transferred as would have been allowed the transferor had the reorganization not occurred.

(i) *Transferor's Income to Be Included in Only One Tax.* Where income of the transferor is required to be included in the computation of a tax on the transferee, such income shall not thereafter be included in the measure of a tax on the transferor.

(j) *"Reorganization" Defined.* The term "reorganization" as used in this section means (1) a transfer by a bank or corporation of all or a substantial portion of its business or property to another bank or corporation if immediately after the transfer the transferror or its stockholders or both are in control of the bank or corporation to which the assets are transferred; or (2) a mere change in identity, form or place of organization however ef-

fected; or (3) a merger or consolidation; or (4) a distribution in liquidation by a bank or corporation of all or a substantial portion of its business or property to a bank or corporation stockholder. As used in this paragraph the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the bank or corporation.

(k) *Tax of Corporations Undergoing Dissolution or Withdrawal.* Any bank or corporation which is dissolved and any foreign corporation which withdraws from the State during any taxable year shall pay a tax hereunder only for the months of such taxable year which precede the effective date of such dissolution or withdrawal, according to or measured by such proportionate part of the net income of the preceding income year as the number of months of the taxable year prior to the effective date of such dissolution or withdrawal bears to the entire preceding income year; provided, however, that in the case of any bank or corporation which is dissolved, or which withdraws from the State during any taxable year, the offset from the tax for the months of such taxable year prior to the effective date of such dissolution or withdrawal shall not exceed that proportion of the offset computed under Section 26 which the number of said months prior to the effective date of such dissolution or withdrawal bears to the number of months of the preceding income year; and provided further, that the taxes levied under this act shall not be subject to abatement or refund because of the cessation of business or corporate existence of any bank or corporation pursuant to a reorganization, consolidation, or merger. In any event, each such corporation shall pay a tax not subject to offset for such period in an

amount equal to the minimum tax provided for in Section 4 of this act.

(l) *Tax of Corporations Resuming Business.* When a corporation discontinues doing business within the State during any taxable year and does not dissolve or withdraw from the State during that year, and does not resume doing business during the succeeding taxable year, its tax for the year in which it resumes doing business shall be computed upon the basis of the net income for the year in which it discontinued doing business (except where such income has already been included in the measure of a tax imposed by this Act), a credit being allowed for any tax payable under subdivision (5) of Section 4 of this act. One-half the amount of such tax shall be due and payable at the time the corporation resumes doing business, or on or before the fifteenth day of the third month following the close of its income year, whichever is later, and the balance shall be due and payable within six months of the time the corporation resumes doing business, or on or before the fifteenth day of the ninth month following the close of the income year, whichever is later, but, in no event shall the balance of the tax be due and payable later than the close of the taxable year in which it resumes doing business. All the provisions of this act relating to delinquent taxes shall be applicable to such tax if it is not paid on or before its due date.

(m) *Tax of Suspended Corporation on Revival.* The tax of any bank or corporation which has suffered the suspension or forfeiture provided in Section 32 of this act, and which revives in any taxable year other than the taxable year in which suspension or forfeiture occurred, but did not transact business, as defined in Section 5 of this act, during the period of such suspension or forfeit-

ure, shall be computed in the same manner as provided in subdivisions (c) and (d) of this section relative to the computation of taxes of banks and corporations commencing to do business for the first time after incorporation or qualification. Such a bank or corporation shall, in addition to the taxes, penalties, and interest specified in Section 33 of this act, prepay a tax in an amount equal to the minimum tax provided for in Section 4 of this act as a condition precedent to the issuance of a certificate of revivor.

(n) *Tax Not a Deficiency Assessment.* Any tax, imposed pursuant to this section, based on the net income as disclosed by the return, shall not be considered a deficiency assessment within the meaning of Section 25 of this act.

(o) *Tax Liability for Short Taxable Years.* The tax liability imposed under this act shall attach whether a bank or corporation has a taxable year of 12 months or of less duration.

Sec. 22. Franchise Tax Commissioner. The Franchise Tax Commissioner, herein referred to, shall be appointed by the Director of the Department of Finance, the Controller of the State and the Chairman of the State Board of Equalization, who are authorized to provide him with such assistants as they may deem necessary, and he shall serve for such period, and for such compensation, and under such conditions, as they may prescribe.

He shall have power and it shall be his duty to administer this act, and to prescribe all such rules and regulations as are necessary and reasonable to carry out its provisions; and said commissioner and the State Board of Equalization, for the purpose of administering their duties under this act, each shall have the powers conferred upon said board by section 3669e of the Political Code of this State.

Sec. 23. Time Taxes Payable and Delinquent. * * *

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Corporations. In the case of corporations of the classes referred to in subdivision (3) of section 4 of this act, one-half the amount of tax disclosed by the return shall be due and payable as a first installment of the tax on such corporations on or before the fifteenth day of the third month following the close of the income year, as defined in section 11 hereof. The balance of the tax shall be due and payable as a second installment on or before the fifteenth day of the ninth month following the close of the income year. A tax imposed by this act or any installment thereof may be paid at the election of the taxpayer, prior to the date prescribed for its payment.

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Sec. 29. Lien of Tax—Commissioner's Certificate. (a) The taxes imposed by this act and disclosed on the return shall constitute a lien upon the real property of the taxpayer, which lien shall have the same force, effect and priority as a judgment lien and shall attach on the last day of the "income year," except that in the case of a bank or corporation incorporated under the laws of this State or a foreign bank or corporation qualified to do business within the limits of this State, after the effective date of this amendment, the lien of taxes for the first taxable year of such a bank or corporation shall attach at the time of such incorporation or qualification. The taxes imposed by this act and determined pursuant to Sections 16, 25 or 28 shall constitute a lien upon all real property of the taxpayer located in any county in which there is filed for record in the office of the county recorder a certificate executed by the commissioner stating that payment of a tax determined under the provisions of Sections 16,

25 or 28 of this act has been demanded and has not been paid and specifying the amount thereof and the name of the taxpayer, and such lien shall attach at the time the certificate is recorded and shall have the same force, effect and priority as a judgment lien. The lien provided for in this section shall remain until the taxes are paid or the property subject to the lien is sold for the payment thereof, or until the lien is released or otherwise extinguished. The commissioner may at any time release all or any portion of the property subject to the lien from the lien or subordinate the lien to other liens if he determines that the taxes are sufficiently secured by a lien on other property of the taxpayer or that the release or subordination of the lien will not endanger or jeopardize the collection of such taxes. A certificate by the commissioner to the effect that any property has been released from the lien herein provided for or that such lien has been subordinated to other liens shall be conclusive evidence that the property has been released or that the lien has been subordinated as provided in the certificate.

(b) No decree of dissolution shall be made and entered by any court, nor shall the county clerk of any county or the Secretary of State file any such decree, or file any other document by which the term of existence of any taxpayer shall be reduced or terminated, nor shall the Secretary of State file any certificate of the surrender by a foreign corporation of its right to do intrastate business in this State unless the taxpayer obtains from the commissioner and files with said court, county clerk or Secretary of State as the case may be, a certificate to the effect the commissioner is satisfied from the available evidence that all taxes imposed by this act have been paid or are secured by bond, deposit or otherwise. Within 30 days after receiving a request for a certificate, the commis-

sioner shall either issue the certificate or notify the person requesting the certificate of the amount of tax that must be paid or the amount of bond, deposit or other security that must be furnished as a condition of issuing the certificate. The issuance of the certificate shall not relieve the taxpayer or any individual, bank, or corporation from liability for any taxes, penalties, or interest imposed by this act.

California Corporation Tax Service:

Par. 5-951.02. Application.—It is our opinion that the amendment by Ch. 352, Laws 1943, to Sec. 4(7) is not an amendment "effecting changes in the computation of taxes" and therefore became effective on May 7, 1943. It follows that the amendment is applicable to all taxes accruing after such date and the tax under the Act now accrues on the last day of the income year in question. We have, therefore, concluded that the amendment is applicable to any income year ending after the effective date of Ch. 352. *Letter of the Acting Franchise Tax Commissioner to Commerce Clearing House, Inc.,* November 17, 1943.

Par. 5-313. Art. 13(m)-1. Dissolving or Withdrawing Corporations—Months Prior to Dissolution or Withdawal.—Section 13(m) (k) of the Act provides that any bank or corporation which is dissolved and any foreign corporation which withdraws from the State during any taxable year shall pay a tax only for the months of such taxable year which precede the effective date of such dissolution or withdrawal, according to or measured by such proportionate part of the net income of the preceding income year as the number of months of the taxable year prior to the effective date of such dissolution or withdrawal bears to the entire preceding income year.

In the application of this provision, the month in which a corporation dissolves or withdraws shall be considered as a full month prior to dissolution or withdrawal, if dissolution or withdrawal occurs after the middle of such month. If dissolution or withdrawal occurs on or before the middle of the month, the month in which the dissolution or withdrawal occurs shall be disregarded. For example, suppose a corporation reporting on a calendar year basis dissolves or withdraws on June sixteenth of a particular year. The tax for the year in which the dissolution or withdrawal occurs will be based on one-half of the income for the preceding year, i. e., on that portion of the income for the preceding year which six months, the number of months preceding dissolution, considering June as a full month bears to the number of months in the preceding year. If the corporation had dissolved or withdrawn during June, but prior to June sixteenth, the month of June would be disregarded. Thus, the tax for the year of dissolution or withdrawal would be based on five-twelfths of the income for the preceding year.

Par. 5-911.04. Foreign corporation's right to do intrastate business.—The annual $25.00 minimum tax may be legally imposed upon foreign corporations qualified to do business in the State, regardless of whether or not that privilege is exercised. The minimum tax is imposed for the right, and not for the exercise of that right. *Opinion of the Attorney General to the Franchise Tax Commissioner,* No. NS 4439, December 1, 1942.

Par. 5-312a. Art. FT 13(k)-No. 1. Effective Date of Dissolution Under Section 13(k).—A taxpayer will be deemed to be dissolved, for purposes of Section 13(k)(1), when it has filed the certificate required by Section 403(c) of the Civil Code.

This regulation shall be applicable to all taxable years commencing after December 31, 1938. For prior taxable years, such dissolution will be deemed to have occurred when the taxpayer distributed all of its assets after the stockholders voted for or consented to such distribution pursuant to Section 400 of the Civil Code.

Authority for this regulation is contained in the following sections of the Bank and Corporation Franchise Tax Act: 13(k)(1), 22, 22.1 and 29. (*As issued December 27, 1945.*)

Par. 8-053. Art. 29-1. Dissolution or Withdrawal of Corporations.—Section 29 provides that no decree of dissolution shall be made and entered by any court, nor shall the county clerk of any county or the Secretary of State file any such decree, or file any other document by which the term of existence of any taxpayer shall be reduced or terminated, nor shall the Secretary of State file any certificate of the surrender by a foreign corporation of its right to do intrastate business in this State until the tax, penalties, and interest shall have been paid.

To facilitate the dissolution and withdrawal of banks and corporations, the Commissioner will issue a certificate to the effect that all taxes, penalties and interest imposed by the Act upon a bank or corporation desiring to dissolve or withdraw have been paid provided the following requirements are met:

1. All returns required under the Act must be filed, and all taxes, penalties and interest for taxable years prior to the year in which dissolution or withdrawal is to occur must be paid.

2. Except in the case of banks, a tax of at least $25 for the taxable year in which dissolution or withdrawal

is to occur, plus any penalties or interest that may have accrued in connection therewith, must be paid. If the bank or corporation has not engaged in any business activities in this State since the beginning of the year in which dissolution or withdrawal is to occur, and does not intend to engage in any such activities prior to dissolution or withdrawal. and if an affidavit to the foregoing effect signed under oath by one of the officers or other duly authorized representative of the bank or corporation is filed, no further taxes need be paid.

3. If the bank or corporation has engaged in business activities in this State since the beginning of the taxable year in which dissolution or withdrawal is to occur or intends to engage in such activities prior to dissolution or withdrawal and if the bank or corporation is not dissolving or withdrawing pursuant to a reorganization, there must be paid for the taxable year in which dissolution or withdrawal is to occur, a tax, computed at the rate provided in the Act, based on that proportion of the net income for the preceding fiscal or calendar year, which the number of months of the year prior to the date on which it is contemplated that dissolution or withdrawal will be effected, bears to the number of months in the preceding fiscal or calendar year. The number of months prior to dissolution or withdrawal shall be determined in accordance with the regulation to Sec. 13(m) issued under date of July 12, 1937.

4. If the bank or corporation is dissolving or withdrawing pursuant to a reorganization, merger or consolidation, there must be paid for the year of dissolution or withdrawal, a tax at the rate provided in the Act based on the entire net income for the preceding fiscal or calendar year. Requests for certificates should state whether

or not the dissolution or withdrawal of the bank or corporation in question is being undertaken pursuant to a reorganization, merger or consolidation.

Any certificate issued pursuant to this regulation will be issued on the assumption that dissolution or withdrawal of the bank or corporation will be effected on or before a specified date. The taxes required to be paid under (3) above will be computed accordingly. Generally, the date specified in the certificate will be the fifteenth of the month following the month in which the certificate is issued, although in special cases a longer or shorter period may be allowed. If, for any reason, dissolution or withdrawal is not effected on or before the date specified, the certificate shall be void, and a new certificate must be obtained. (*Adopted October* 5, 1937.)